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SIPDIS

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TAGS: EFIN PREL ECON TU
SUBJECT: CENTRAL BANK RATE CUT REINFORCES MARKET'S
INCREASING BULLISHNESS

REF: ISTANBUL 1371

1, (U) Summary: After a range-bound summer, Turkish markets have rallied in early September. First the stock market rallied on increasingly favorable signals regarding EU accession and an IMF program, then the Central Bank cut its short-term rates 200-400 basis points. By its action, the Central Bank appears confident the end-year inflation target will be met, and does not appear overly concerned about the growing current account deficit. The rate cut, surprising markets by its magnitude and timing, in turn broadened the rally to the government securities market in a gloabal market environment where funds are still flowing to emerging markets. Though a Central Bank rate cut would normally cause a currency to weaken, market bullishness caused the lira to strengthen through foreign inflow. On Friday, September 10, second quarter GDP growth came it at a whopping 11.9 percent, confirming that the economy is likely to grow well above its 5 percent target for 2004, but reinforcing concerns about overheating and the current account deficit. End Summary.

First, a Stock Market Rally:

¶2. (U) Following the spurt of volatility in April and May after a shift in expectations regarding global interest rates, markets settled into a mostly range-bound summer. The exchange rate has been remarkably stable, hovering around 1.5 million TL to the dollar and the benchmark bond has been stuck in the mid-twenties of percent, with increasingly positive inflation numbers seemingly having little effect on nominal rates. The benchmark bond, which was yielding over 27 percent at the end of June, had only improved to 25.13 percent at the end of August. The more volatile, and less meaningful, stock market gradually moved up from its late spring lows, while remaining below the level it achieved in April, prior to the volatility.

¶3. (U) Even the long-awaited, market-critical decision in August that the GOT would definitely seek a follow-on disbursing Standby arrangement from the IMF, failed to move markets. But at the beginning of September, as Turks drifted back from vacation, the Turkish stock market began moving upwards on increasing optimism over Turkey,s prospects of getting a date to begin EU accession negotiations. After rising 2.95 percent the week of August 23-27, the IMKB-100 rose 4.63 percent to 20,775 the week of August 30-September 3, after positive comments on Turkey,s EU accession prospects by UK Foreign Minister Straw and EU Enlargement Commissioner Verheugen.

¶4. (U) The stock market optimism, however, failed to make a dent in the foreign exchange or government securities markets. The yield on the benchmark bond, for example, was actually slightly higher, at 25.41 percent at the close September 7 then it had been on August 27, when it traded at 25.13. Likewise, the lira was at 1.505 million to the dollar September 7, versus 1.504 million on August 27.

Then, a Surprising Interest Rate Cut:

¶5. (U) On Wednesday, September 8, the Central Bank surprised markets by cutting its overnight lending rates by 200 basis points. Most analysts were surprised both by the timing and magnitude of the rates. The Bank had been gradually cutting rates in 2003 and the first quarter of 2004, in line with the fall of inflation, and markets were expecting further rate cuts until the April-May volatility spooked Turkish financial markets and

put Bank rate-cutting on hold.

¶6. (U) The rate cut, and the convoluted accompanying announcement, left many analysts scratching their heads, particularly as regards the timing. The Central Bank has on several occasions waited until the GOT reached agreement with the IMF staff on a review before cutting rates, yet this time the Bank cut two weeks prior to the planned arrival of an IMF mission to begin negotiating a follow-on program. Moreover, the August inflation numbers, announced a few days prior to the rate cut, surprised on the high side. The Central Bank is reportedly being criticized by AKP economists on the grounds that the Central bank caused the Treasury to borrow at higher yields in the recent Treasury auctions, where Treasury borrowed at av. 25-26%.

¶7. (SBU) These factors were apparently outweighed in the Bank,s thinking by some combination of the following:

--First and foremost, though the August inflation numbers came in above expectations, most analysts still believe the year-end twelve percent inflation target is attainable. With CPI for the first eight months of 2004 at only 3.9 percent (though WPI and year-on-year numbers are higher) the Bank,s confidence seems justified. Central Bank Markets Department Deputy General Manger Emrah Eksi stressed the expected continuation of the disinflation trend in his private comments to Economic Specialist.

--The GOT,s decision to pursue an IMF program. In its statement, the Bank Central Bank Governor Serdengecti had been publicly urging the GOT to seek a follow-on program for months, so much so that Deputy Prime Minister Sener rebuked him in August (without referring to him by name) saying a "bureaucrat" should not tell the Government what to do. The Central Bank is reportedly being criticized by AKP economists on the grounds that the Central bank caused the Treasury to borrow at higher yields in the recent Treasury auctions, where Treasury borrowed at av. 25-26%. The Bank may have been waiting for the GOT decision to make an overdue rate cut, but did not want to juxtapose too closely its rate cut to the GOT,s IMF decision.

--Signs of market confidence, favorable hints on EU accession. As noted above, the stock market was beginning to rally over bits of good news on the EU front. With signs of increased market bullishness increasing flows of lira-strengthening short-term portfolio investment, the Bank may have felt the timing was right to lower rates, which would normally dampen such flows and work against a possible overvaluation of the lira.

--Finally, the Bank, like most Central Banks, likes to keep markets guessing on its timing. If this was one of its goals, it was highly successful.

Government Securities and Lira rally:

¶7. (U) The previously-immobile Government Securities market took heart from the rate cut though the yield on the benchmark bond fell only 95 basis points (half the central Bank,s rate cut) on the first day after the cut. Benchmark rates fell a further 23 basis points the following day (September 9), however, reaching 24.23 percent, the lowest level since before the upward shift in global interest rates in late April. Rates have stayed roughly at that level since, with the benchmark at 24.37 at the close September 14. In the external debt market, the GOT capitalized on the uptick in sentiment towards Turkey to announce issuance of $600 million in Euro-denominated Eurobonds, yielding only 5.75 percent.

¶8. (U) More surprisingly, since lower interest rates would normally lead to a weakening of the currency, the lira rallied on September 8 and 9, appreciating from 1.503 million TL per dollar to 1.485 million TL. The broader bullishness on Turkey, and apparently a market assumption that the Central Bank would not have cut rates without knowing things were getting better, led markets to buy into lira, even despite normally lira-depressing large purchases of foreign exchange by local corporates on September 9. On Friday and early this week, the lira lost some of its gains, however, depreciating to TL 1.491 million at the close September 14.

¶9. (U) The rate cut and broader market bullishness overwhelmed surprisingly harsh comments from EU Commissioners Fischler on September 5 and Bolkestein on September 7, as their views are widely reported to represent those of a minority of commissioners opposed to

giving Turkey a date. The IMKB 100 reached 21,398 at the close September 9. On Friday, the 10th and Monday and Tuesday, the stock market traded slowly downward as markets became increasingly over the potential effects of the adultery law debate on EU accession prospects, before rebounding to 21,705 at the close September 14 on news suggesting the GOT might shelve it's controversial adultery law proposal.

Strong GDP growth Reinforces Concerns about the Current Account Deficit:

¶10. (U) Two days after the rate cut, on September 10, the State Statistical Institute announced second quarter GDP and GNP growth numbers that were well above analysts, expectations. In the second quarter, GDP grew 13.4 percent and GNP 14.4 percent in real terms. For the first six months of the year, GDP grew 11.9 percent and GNP 13.5 percent. Though most analysts expect growth to slow somewhat in the second half, the new numbers confirm that Turkey,s economy will grow well above the 5 percent growth target for 2004. Most private analysts have now revised their full-year 2004 forecasts upward, with most predicting an extraordinarily strong 8 or 9 percent real growth.

¶11. (U) Though the signs of strong growth would normally be a welcome sign of the economy's continued recovery from the 2000-2001 crisis, they reinforce concerns about the growing current account deficit. Along with many private analysts (reftel) former Treasury Undersecretary Faik Oztrak added his voice to those raising concerns about excessively strong growth and the link to the current account deficit, in an op-ed September 13.

¶12. (Sbu) IMF staff, however, seem to be among the least alarmed about the growing current account deficit. IMF Resrep Hugh Bredenkamp, however, and his Deputy Christoph Klingen, at a meeting just prior to the announcement of the growth numbers, said Fund staff is concerned but that there is no clear consensus in favor of immediate action. Bredenkamp and Klingen said so far the Fund favors only maintaining the 6.5 percent primary surplus target to dampen domestic demand (and therefore imports), allowing the automatic stabilizer of the floating exchange rate regime to work, passing through world oil price fluctuations without delay, and building up Central Bank and Treasury reserves as a precaution.

Comment and Conclusion:

¶13. (Sbu) The Central Bank rate cut reinforced the uptick in market sentiment. The market bullishness, combined with the strong growth numbers that followed, however, can only exacerbate concerns that the current account, and the possibility of a sharp fall in the lira and reversal of portfolio investment flows in late 2004 or 2005, particularly if Turkey faces an exogenous shock. Many analysts consider the lira overvalued, and its continued strength augurs ill for the hoped-for moderation in import growth. With markets headed for a volatile period because of the drip of news on both the IMF negotiations and the prospects for a date for EU accession talks, the build-up of imbalances from the current account is likely to increase Turkey's vulnerability to a sharp correction.

EDELMAN